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Supreme Court of the United States

OCTOBER TERM, 1935.

No. 173

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

SAMUEL A. SALVAGE.

No. 280

SAMUEL A. SALVAGE,

Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE.

BRIEF FOR SAMUEL A. SALVAGE, Petitioner.

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

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ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

Opinions Below.

The opinion of the Board of Tax Appeals (R. 28-32) is unreported.

The opinion of the Circuit Court of Appeals (R. 74-78) is reported in 76 Fed. (2d) 112.

Jurisdiction.

The judgment of the Circuit Court of Appeals reversing the decision of the Board of Tax Appeals in part and affirming it in part was entered on March 25, 1935 (R.

78). Writs of certiorari were granted on cross petitions on October 14, 1935 (R. 79, 80). The jurisdiction of this court is invoked under Section 240-a of the Judicial Code as amended by the Act of February 13, 1925, and Section 1003 of the Act of February 26, 1926, Chapter 27, 44 Stat. 110.

Questions Presented.

The questions before the court involve the correct determination of the income tax liability of the petitioner Salvage for the year 1929. The Commissioner, having audited the taxpayer's return, asserted a deficiency of $12,005.38. The taxpayer denied the existence of the claimed deficiency and claimed a refund of $63,750.

The Board of Tax Appeals sustained the Commissioner. The Circuit Court of Appeals in part affirmed the Board of Tax Appeals and reversed its decision to an extent which allowed a refund, although not the full amount claimed. Both parties petitioned for writs of certiorari for a review by this Court of the parts of the judgment of the Circuit Court of Appeals which were adverse to their respective claims, which petitions were granted. The questions are:

1. In No. 173, whether the taxpayer is estopped to claim that the difference between the market value of 1500 shares of stock as of December 30, 1922, and their cash cost to him constituted taxable income to him for 1922, and hence that the fair market value of these shares and not their cash cost is the basis to be used in measuring gain from the disposition of a part of the shares in 1929, no income from the transaction having been reported in 1922.

2. In No. 280, whether the proper cost base of the preferred stock redeemed in 1929 should be arrived at by an apportionment of (1) the true value of or (2) the cash paid for the stock.

3. In No. 280, whether the Circuit Court of Appeals exceeded its jurisdiction in making the finding of such value.

Statement of Case.

Samuel A. Salvage, commencing about 1910 (p. 36) and through the entire period involved in this proceeding, was an employee and officer of The Viscose Company, or its predecessors, a corporation engaged in the manufacture and sale of rayon yarn (pp. 23, 37).

The growth of the business was phenomenal. Its production increased from 320,000 pounds of yarn in 1911 to over 19,000,000 pounds in 1922 and to over 75,000,000 pounds in 1933 (pp. 38, 39, 40). In recognition of his value to the company, the shareholders in 1919 offered to increase his compensation but Salvage failed to take up the offer (pp. 38, 43). To remedy this, the stockholders and Directors, on December 15, 1922 authorized an increase of 4,000 in the corporation's outstanding shares and the sale of 1500 of these shares to Mr. Salvage at par (pp. 48-50).

The contract of sale provided as follows:

> "Whereas the Company has, in consideration of the agreement of Salvage hereinafter set forth, sold to him or his nominees 1,500 shares of its capital stock at par, and has issued certificates therefor as directed by Salvage.
>
> Now This Agreement Witnesseth:
>
> 1. That Salvage does hereby agree to and with the Company that the said Company shall have the right to repurchase from him or his nominees, and he does hereby undertake, on behalf of himself, his heirs, executors, administrators, and assigns, to procure for and deliver to the said Company for repurchase at par the following proportions of the said 1,500 shares:
>
> At any time during the year 1923, five-sevenths;
> At any time during the year 1924, four-sevenths;
> At any time during the year 1925, three-sevenths;

At any time during the year 1926, two-sevenths;
At any time during the year 1927, one-seventh of the said 1,500 shares.

2. Salvage does further hereby agree to and with the Company that he will not at any time during his life in any part of the United States of America, except the States of Utah, Nevada, and New Mexico, Canada, the United Kingdom of Great Britain, or the Free State of Ireland, directly or indirectly, alone or in partnership, or as a Director or other Officer of a corporate body or as an Agent or otherwise howsoever, carry on or be engaged in any trade, business, or occupation for the manufacture or production of artificial silk, rayon, or Viscose, or of any material, goods, or articles from Viscose in any form, nor enter into the service of or, directly or indirectly, assist or act for any person, firm, or corporation in such trade or business or manufacturing, or contemplating the manufacture of, artificial silk or rayon, without the express written consent of the said Company."

(Exhibit C, p. 10, annexed to the petition, repeated as Exhibit A, p. 14, to Stipulation of Facts)*.

At the same time a contract of employment dated back to January 1, 1922, was entered into (Exhibit 5, p. 57). It should be noted that the expiration dates of the employment contract and of the stock options are the same. The minutes of the stockholders' and directors' meetings of December 15, 1922, contain no mention of the stock repurchase contract but with respect to employment the Directors' minutes state: "Resolved that the company enter into a new service agreement with * * * Mr. Samuel A. Salvage dating as from January 1st, 1922, for a period of six years in the form presented to the meeting * * *." (p. 50)

On December 30, 1922, the same day that the stock contract was entered into, a new company was organized called American Viscose Corporation. That company issued four

* This contract superseded the document printed at pages 54 and 55 of the Record. See paragraph 3 of Stipulation, p. 13, and Statement of Counsel, p. 16.

shares of its 7% preferred stock, callable at $110. per share, and five shares of its common stock in exchange for each share of stock of the old Viscose Company. (Stipulation of Facts, paragraphs 1 and 2, pp. 12 and 13.) By this exchange, the taxpayer became the owner of 6100 shares of preferred stock and 7615 shares of the common stock of the new company.* The repurchase rights reserved by the old company in the contract of December 30th were extended to these shares by an exchange of letters (Exhibits 3 and 4, p. 56). In 1929 American Viscose Corporation redeemed all of its preferred stock at its call price of $110. per share and Mr. Salvage received $671,000. for the 6,100 shares held by him (Petition V (c), p. 4; Answer V (c), p. 12).

The issue to be decided is what part of this sum of $671,000. is taxable income. The taxpayer took the position that it was impracticable to apportion between the preferred and common stock of the new company the percentage of the cost of his original stock to be attributed to each (Article 1576, Regulation 62) and his return for the year 1929 showed the transaction as follows (p. 27):

SCHEDULE D—CAPITAL NET GAIN OR LOSS FROM SALE OF ASSETS HELD MORE THAN 2 YEARS:

1. Kind of Property	2. Date acquired	3. Date Sold	4. Amt. Received	6. Cost, etc.	8. Net Gain, etc.
6100 Amer. Viscose Co: pfd. stock redeemed	1919–22	10/1/29	$671,000.	$154,166.66	$516,833.34

The Commissioner of Internal Revenue proceeded in due course to an audit of Mr. Salvage's return. During this audit, as the Commissioner acknowledges (p. 8), Mr. Salvage furnished the Field Examiner with a memorandum prepared by Price Waterhouse & Company, the Company's auditors, which found a value as of December 30, 1922, for the old shares of $1164.70, and apportioned this value to the

* This took into account 25 shares of the old Company previously purchased by the taxpayer at $166.66 per share (Answer V (a) p. 12).

new preferred and common shares (Exhibit C, pp. 18-22). On the basis of this memorandum the Commissioner fixed the base value of the redeemed stock at $58,123.47, thereby adding to taxable income the sum of $96,043.19 and proposed an additional tax of $12,005.38. (See statement dated November 30, 1931, of Revenue Agent enclosed with Sixty Day Letter, pp. 7 and 8.)

Mr. Salvage, to protect his position, and although still contending that his theory of the return was correct, then filed a claim for refund asserting that if, as claimed by the Commissioner, an apportionment was practicable and the stock when acquired had a value of $1164.70 per share, that that figure and not the cash cost of $100. per share must be taken as the basis and if so taken he was entitled to a refund of $63,750.

Thereafter the taxpayer received the usual sixty day letter from the Commissioner and filed his petition for a redetermination of the proposed findings of the Commissioner, claiming *first,* then and at all times thereafter, that his return was correct, that it was in fact impracticable to make any fair apportionment as the company's books did not reflect the value of the shares of The Viscose Company on December 30, 1922, and, accordingly, that no taxable gain could have been received by the taxpayer until the whole amount paid by him for the stock had been recovered by him; and, *second,* if this claim were disallowed that the base cost of the preferred stock to the taxpayer was its actual value on the date when received by him, and not a fraction of the cost of $100. per share, and the difference between the two figures, representing the consideration for the stock purchase contract, was not taxable in 1929 (pp. 3, 5). The Commissioner's answer (p. 11) consisted of denials of the essential allegations and set out no affirmative defenses.

The Board of Tax Appeals disallowed all of the taxpayer's claims and sustained the apportionment made by the Commissioner on the basis of the Price, Waterhouse

memorandum supplied by the taxpayer (pp. 28-32). No matter relating to any affirmative defense was referred to in the opinion of the Board (pp. 28-32).

The taxpayer then filed his petition for a review of the Board's decision by the Circuit Court of Appeals for the Second Circuit (p. 32). In an opinion by Judge Swan (76 Fed. 2d. 112, R. pp. 73-78) the Court held that the difference between the cash cost to Mr. Salvage of the shares purchased in 1922 and the actual value represented income paid to him under the contract of December 30, 1922, in exchange for his covenant not to engage in a competing business, that the actual value was restricted as to five-sevenths of the shares by the price at which The Viscose Company had reserved the right of repurchase, and as to the balance was the value found by the Commissioner, i. e. $1,164.70 per share; that on this basis the taxpayer was entitled to a refund to compute which the case was ordered remanded. The Court further held that the taxpayer was not estopped by his failure to report as income in 1922 the difference between one hundred dollars per share and the true value.

From that decision the case has come to this Court on cross writs of certiorari.

Specification of Errors.

1. In No. 173 the Commissioner specifies that the Circuit Court of Appeals erred:

In failing to hold that the taxpayer was estopped to claim that the basis for measuring the gain from the redemption of his new stock in 1929 was the fair market value of the old stock when acquired in 1922 by his failure to report the difference between the cost and fair market value as income for 1922.

2. In No. 280 the taxpayer specifies that the Circuit Court of Appeals erred in holding that the cost base of the preferred stock of American Viscose Corporation redeemed

in 1929 was to be arrived at by taking as the fair market value of The Viscose Company stock the sum of $100. per share, insofar as the five-sevenths of said stock which was subject to the option to repurchase was concerned.

3. In No. 280 the taxpayer specifies that the Circuit Court of Appeals erred in making a finding as to the value of said option stock.

Summary of Argument.

The points of the petitioner Salvage are as follows:

1. The defense of estoppel is not available to the Commissioner. He argues that the statutes authorize the Board of Tax Appeals to make its own rules of practice and procedure; that the rules of the Board require that the Commissioner state any facts in his answer upon which he relies for affirmative relief, and that the burden of proof is upon the Commissioner to sustain any such defense; that the answer of the Commissioner in this case contained no plea of estoppel, and that had it done so the taxpayer would have been afforded an opportunity to present such facts as were available in opposition to such defense.

2. That even if the defense of estoppel is available to the Commissioner, nevertheless it is not established by the record. He argues that the elements held by the decided cases to be necessary to sustain a defense of equitable estoppel do not exist in this case; that there was no intended deception by the taxpayer nor was he guilty of gross negligence or constructive fraud; that the Commissioner had available means of acquiring all facts necessary to protect himself, and that the record does not show that the Commissioner was damaged in any way.

3. That the Circuit Court of Appeals erred in holding that five-sevenths of the 1500 shares of The Viscose Company stock subject to the option to repurchase had a value

of only $100. per share. He points out that by the terms of the contract itself the taxpayer purchaser was perfectly free to dispose of the stock and that if he had sold it the only right lying in the seller would have been an action for breach of contract; that a consideration of all the facts shown by the record, in connection with the relations existing between the purchaser and the seller of the stock, demonstrates that there was never any intention that the options to repurchase would be exercised, unless the purchaser breached his contract of employment; that even though the Court should hold that the repurchase options did diminish the value of the stock in 1922, the full value was received by the taxpayer as the options expired, and the difference was not subject to taxation in 1929.

4. That the Circuit Court of Appeals erred in making a new finding as to the value of the optioned stock. The argument on this point is based upon the contention that the Board of Tax Appeals from the evidence before it had found a value of $1,164.70 for all of the stock, including that which was subject to the option and that under the cases the Circuit Court of Appeals was obliged to accept this finding of fact as conclusive.

POINT I.

The defense of estoppel is not available to the Commissioner.

The sole ground advanced by the Commissioner in his petition for a writ of certiorari is that the taxpayer is estopped from claiming that the basis for determining his gain is the true value of the stock acquired by him on December 30th, 1922. It is asserted in the petition for the writ (pp. 8, 9) that:

> "The case is one in which the taxpayer is claiming now that income was derived from the receipt

> of the stock in 1922 and a new basis established for measuring gain from the disposition of the stock in 1929, after he had previously taken the contrary position and induced the Government to rely upon it to the Government's detriment. There was thus a failure to disclose a transaction which the taxpayer was required to disclose in its sworn return, a reliance upon the taxpayer's act by the Government, and a subsequent reversal of position by the taxpayer to the Government's detriment. The existence of these elements is all that is required to establish equitable estoppel or estoppel *in pais*."

We submit that estoppel is an affirmative defense and, hence, must be pleaded and proven under the Rules of the Board of Tax Appeals and the authorities.

The Board has power to prescribe its rules of practice and procedure.

Section 907-(a) Revenue Act of 1924, as amended by Section 1000, Revenue Act of 1926 and Section 601 of the Revenue Act of 1928.

Rule 14 of the Board requires the Commissioner to file an answer which shall contain

> "A specific admission or denial of each material allegation of fact contained in the petition and a statement of any facts upon which the Commissioner relies for defense or for affirmative relief, or to sustain any issue raised in the petition in respect of which issue the burden of proof is by statute placed on the Commissioner."

The Board in a recent decision held that estoppel must be pleaded and proven. *Swiss Oil Co.* v. *Commissioner,* 32 B. T. A., decided June 14, 1935.

See also

Sugar Creek Coal & Mining Co., 31 B. T. A. 344, 346.

Helvering v. *Brooklyn City Ry. Co.,* 72 F. (2d) 274.

Gilmer v. *Poindexter,* 10 Howard 257.

The Commissioner's answer (pp. 11, 12) contains no mention of an estoppel, and that defense was never presented until it was urged in the Commissioner's brief on the reargument in the Circuit Court of Appeals. The taxpayer's position, which it is now claimed he was estopped from taking, on the other hand was clearly presented in his petition to the Board. He alleged:

> "As a consideration of the right given to the taxpayer he agreed that he would not at any time during his life engage in any trade, business, or occupation for the manufacture or production of artificial silk or any material, goods, or articles from the same, nor enter into the service of any person, firm, or corporation engaged in such business, without the express written consent of said company. A copy of said contract is hereto annexed and marked 'Exhibit C'." (p. 3)
>
> * * * * * *
>
> "Wherefore, petitioner prays that this Board may hear the proceeding and determine:
>
> * * * * * *
>
> (2) That the base cost of the preferred stock to the taxpayer was its actual value on the date when received by him and not a fraction of the sum of $100. per share.
>
> (3) That no taxable gain was realized by the taxpayer upon the redemption of the preferred stock of American Viscose Corporation in 1929." (p. 5)

Had the issue of estoppel been raised by the Commissioner, either by his pleadings or on the trial, for aught that appears, the taxpayer might have been able to show he had no taxable income in 1922 on any basis of computation or that the Commissioner was fully advised of the transaction when the return was audited, or, as the Circuit Court of Appeals states in its opinion, that he might "for all that this record discloses, have mentioned the purchase in his 1922 return" (p. 77). He might further have shown that the equities lay against the Commissioner. On cross-

examination by the Commissioner's counsel Mr. Salvage was asked (p. 42):

> "Q. Can you state whether the Viscose Company in 1922 made any deduction in its return for salary or compensation paid to you other than that which you reported in your return?
>
> A. No; it did not.
>
> Q. Are we to understand, then, that the Viscose Company made no deduction by reason of the value of this stock over and above $100.?
>
> A. It did not * * *."

Had The Viscose Company made such a deduction it would have saved in taxes 12½% thereof. There is nothing to show that this gain by the Treasury exceeds the loss, if any, that it may have suffered by the failure of the taxpayer to report his purchase in accordance with the bargain-purchase theory promulgated by the Commissioner for the first time about a month before the taxpayer's return was due in a Treasury Department ruling.

The case was tried for the Commissioner before the Board on the theory that the difference in value of the shares purchased on December 30th, 1922, between the cash purchase price of $100. and the true value was not compensation for services. To now urge estoppel is, in effect, an admission to the contrary.

> "After bringing and trying the case on that theory the plaintiff can not be permitted on this review to change to another which the defendant was not required to meet below". *Virginian Ry. Co.* v. *Mullens,* 271 U. S. 220, 227, 228.

POINT II.

If the Court shall hold that equitable estoppel is available to the Commissioner as a defense, nevertheless it is not established by the record.

This Court has defined equitable estoppel—the defense here urged—in a number of cases from which we quote the following:

> "For the application of that doctrine there must generally be some intended deception in the conduct or declarations of the party to be estopped, or such gross negligence on his part as to amount to constructive fraud, by which another has been misled to his injury. 'In all this class of cases', says Story, 'the doctrine proceeds upon the ground of constructive fraud or of gross negligence, which in effect implies fraud. And, therefore, when the circumstances of the case repel any such inference, although there may be some degree of negligence, yet courts of equity will not grant relief. It has been accordingly laid down by a very learned judge that the cases on this subject go to this result only, that there must be positive fraud or concealment, or negligence so gross as to amount to constructive fraud.' 1 Story's Eq. 391."
>
> (*Brant* v. *Virginia Coal & Iron Co. et al.*, 93 U. S. 326, at pp. 334, 335.)

> "The principle of estoppel is well settled. It precludes a person from denying what he has said or the implication from his silence or conduct upon which another has acted. There must, however, be some intended deception in the conduct or declarations, or such gross negligence as to amount to constructive fraud. *Brant* v. *Virginia Coal & Iron Co.*, 93 U. S. 326; *Hobbs* v. *McLean*, 117 U. S. 567. And in respect to the title of real property the party claiming to have been influenced by the conduct or declarations must have not only been destitute of knowledge of the true state of the title, but also of any con-

venient and available means of acquiring knowledge. Where the condition of the title is known to both parties, or both have the same means of ascertaining the truth, there can be no estoppel. *Brant* v. *Virginia Coal & Iron Co.*, supra."

(*Crary* v. *Dye*, 208 U. S. 515, at p. 521.)

"Only where conduct or statements are calculated to mislead a party and are acted upon by him in good faith to his prejudice can he invoke them as a basis of such an estoppel."

(*Oklahoma* v. *Texas*, 268 U. S. 252 at page 257.)

"The circumstances presented by this record do not show that the assured was deceived or misled to his detriment."

(*Wilber Nat. Bank* v. *United States*, p. 405, Vol. 79, No. 7, Sup. Ct. Advance Opinions.)

"An equitable estoppel is raised when there is some intended deception in the conduct or declarations of the party to be estopped, or such gross negligence on his part as to amount to constructive fraud, by which another has been misled to his injury."

(*Hobbs* v. *McLean*, 117 U. S. 567, at p. 580.)
See also Bigelow on Estoppel, 6th Ed. p. 682.

The application of these definitions to the present case raises the following questions:

(a) Is there any intended deception found in the conduct or declarations of the taxpayer?

(b) Was the taxpayer guilty of such gross negligence as to amount to constructive fraud?

(c) Was the Commissioner destitute of any convenient and available means of acquiring knowledge?

(d) Assuming the taxpayer's conduct or statements were calculated to mislead the Commissioner, were they acted upon by him in good faith and to his prejudice?

We believe the record clearly answers these questions in favor of Mr. Salvage. In the first place, never at any time either in the record or in the briefs has any suggestion been made that the taxpayer did not act in entire good faith. The Circuit Court of Appeals said (Rec. pp. 76, 77):

> "So far as appears, the petitioner's failure to report the income in 1922 was due to an innocent mistake of law; he made no false representations of fact, and may, for all that this record discloses, have mentioned the purchase in his 1922 return."

Moreover, when Mr. Salvage purchased his shares in 1922 the "bargain purchase" theory was not known.

T. D. 3435 promulgated February 7, 1923, II-1 C. B. 50, was the first announcement of the so-called "bargain purchase" theory. It provided in substance that,

> "Where property is sold by a corporation to a shareholder or member, or by an employer to an employee, for an amount substantially less than its fair market value, such shareholder or member of the corporation or such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value. In computing the gain or loss from the subsequent sale of such property its cost shall be deemed to be its fair market value at the date of acquisition."

The bargain-purchase theory has since been approved in many decisions and is now Article 22(a)-1 of Regulations 86.

It is true that this Treasury decision was promulgated a little more than a month before the taxpayer filed his 1922 income tax return but there is no evidence that it was in general circulation by that time or that it came to his notice. Certainly the situation is not such as to furnish a basis for a charge of intended deception or gross negligence.

The basis of the taxpayer's 1929 return would seem to be immaterial in view of the fact that it was promptly audited by the Commissioner and every detail of the stock

purchase and redemption disclosed not later than November 30, 1931 (Statement of Revenue Agent, pp. 6, 7, 8). No question of the taxpayer's good faith has been or can be raised in connection with his 1929 return. He adopted as the basis for his 1929 return Article 1567 of Regulations 62, issued under the Revenue Act of 1921, which provided in part:

> "If property is exchanged for two kinds of property and no gain or loss is recognized under Articles 1564 or 1566, the cost of the original property should be apportioned if possible between the two kinds of property received in exchange for the purpose of determining gain or loss upon subsequent sale. If no fair apportionment is practicable no profit on any subsequent sale of any part of the property received in exchange is realized until out of the proceeds of sale shall have been recovered the entire cost of the original property."

As shown by his return he deducted from the proceeds of the redemption of the preferred stock the entire cost of his original stock purchase and reported the difference as a capital net gain (Schedule D, p. 27). This was a simple and straightforward method which left the entire proceeds of all future sales of stock taxable. The reason for its adoption is found in the case of *The Viscose Company*, 3 B. T. A. 444, 458, in which the Board found as to the capital of the Viscose Company

> "• • • it is impossible to determine the value of the mixed aggregate of tangible and intangible property."

The conditions of the business which brought the Board to that conclusion still obtained in 1929 according to the testimony of Mr. Salvage (pp. 39, 40, 41). Briefly, these were omission from the capital account (1) of expenditures for plant development paid from current income; (2) of the value of contract and patent rights; and (3) of secret processes (see also petitioner's Exhibits 6, p. 59; 7, p. 63; 8, p. 65).

The Board of Tax Appeals, however, sustained the Commission's allocation (p. 31) based on the Price, Waterhouse memorandum (p. 18) which Mr. Salvage had with commendable frankness supplied the Auditing Field Agent (p. 8). The Circuit Court of Appeals held that:

> "The taxpayer has not proved that the market value ascribed by the Board to preferred and common stock was erroneous or that no fair apportionment between them of the cost of the old stock was practicable" (p. 78).

As there is relevant evidence to sustain these conclusions we take it that the taxpayer is foreclosed from further argument to sustain his original position (*Phillips* v. *Commissioner*, 283 U. S. 589) but the facts do sustain his continued good faith.

Under the definitions, the Commissioner in order to succeed on the defense of equitable estoppel must also establish that he was destitute of any convenient and available means of acquiring knowledge. The Revenue Act in effect in 1921 required the taxpayer to keep adequate records of all business transactions and gave the Commissioner full authority to audit the taxpayer's records (Article 1711, Reg. 62). Had such an audit been made with respect to the year 1922, as it was made with respect to the year 1929, there is no reason to suppose that the same disclosure as was made by the taxpayer concerning his 1929 transactions would not likewise have been made concerning his 1922 transactions. No evidence was offered by the Commissioner as to whether or not any such audit was made, and if he failed to avail himself of the convenient means of acquiring full knowledge of the facts relevant to Mr. Salvage's income tax liability, is he not the one to suffer the consequences?

For all that appears in this case, the purchase of this stock was disclosed by the taxpayer in his 1922 return. That return was in the Commissioner's possession and if he had had the slightest idea of attempting to prove an

estoppel as against the taxpayer he should have placed it in evidence.

Finally, under the definitions of equitable estoppel, we have the question of whether the Commissioner was in fact misled and damaged. In the preceding point, (*ante*, p. 10) to which we respectfully refer the Court, it has, we believe, been shown that evidence of damage or prejudice to the Commissioner is totally lacking and that it is indeed possible that as a result of all of the transactions the Treasury Department may be the gainer. The evidence on these matters was in the possession of the Commissioner. Under the authorities the burden of proof was upon him and we submit that, as no such evidence was introduced, he has failed to sustain that burden and the defense of equitable estoppel must be dismissed.

> "But, if the question of the essential unfairness of this petitioner's position be open to consideration, there is still not enough to support the respondent's affirmative plea. The petitioner has not misled the respondent. So far as the evidence shows, petitioner has merely filed erroneous returns in which the Commissioner has acquiesced. There is no explanation of the error by either side. Both have known all the facts, certainly since 1922, and we may assume, in the absence of contrary evidence at least, that the Commissioner before that did his official duty and likewise ascertained them." *Sugar Creek Coal & Mining Co.* v. *Commissioner of Internal Revenue*, 31 U. S. Bd. Tax Ap. Repts, 344, at p. 347. Acquiesced in by Commissioner XIV.-1, C. B., p. 20.

POINT III.

The Circuit Court of Appeals erred in holding that five-sevenths of the 1500 shares of Viscose stock subject to the option to repurchase had a value of only $100. a share.

The Circuit Court of Appeals in its opinion (p. 78) said:

> "Because of the option, each optioned share of Viscose had a value of only $100., and the block of

> American Viscose for which it was exchanged also had a value of only $100. because as a block it was subject to the option."

Putting it another way, the court held that stock having an admitted *value* of $1,164.70 a share, was immediately reduced to a *value* of only $100. a share because of the option to repurchase at that figure.

The option contract appears at p. 10 of the record. It is essential to consider its terms carefully to determine what effect, if any, it had upon the *value* of the 1500 shares of Viscose stock sold to Salvage.

The contract recites that the company

> "has in consideration of the agreement of Salvage hereinafter set forth, *sold to him or his nominees* 1500 shares of its capital stock at par, *and has issued certificates therefor as directed by Salvage.*" (Italics ours.)

Salvage on his part agreed that the company

> "shall have the right to repurchase from him *or his nominees,* and he does hereby undertake, on behalf of himself, his heirs, executors, administrators *and assigns, to procure for and deliver to* the said Company for repurchase at par the following proportions of the said 1500 shares." (Italics ours.)

The italicized language shows clearly that it was not intended that Salvage should during the life of the option retain the identical certificates of stock which had been issued "as directed by" him. On the contrary, it clearly appears that some of the shares were "sold to him or his nominees," otherwise there would have been no reason why he should "undertake, on behalf of * * * his * * * assigns, (i. e., nominees) to procure for and deliver to the said company" such shares as it might wish to repurchase.

There is nothing in the contract which would have prevented Salvage from assigning the entire 1500 shares to any number of assignees. There is nothing in the con-

tract which would have prevented him from selling or assigning the 1500 shares at $1,164.70 a share (their conceded fair market value) or at any other price obtainable. His agreement was "to procure for and deliver to the said company for repurchase at par" such shares as the company might, within the periods stated, conclude to repurchase. That agreement would have been complied with had Salvage delivered certificates for the called for number of shares, even though not the identical certificates originally issued to him or his nominees.

Since Salvage was free to dispose of the stock by sale or assignment for value, the stock did have a value in his hands in excess of $100. a share, and that value was $1,164.70 a share (p. 14).

As the option did not appear on the stock certificates themselves, it is clear that a purchaser from Salvage without notice, would, since a properly exeeuted assignment of a stock certificate makes it negotiable, have acquired a good title to the shares represented by the certificate. Even if it were possible to construe the option contract as requiring Salvage to sell back to the company the identical certificates originally issued to him, his failure or inability to do so, would merely be a breach of contract between him and the company and would not affect the rights of a purchaser from Salvage, or his assignee.

Salvage, therefore, was in a position where he could have sold the stock, and the buyer would have acquired a good title. Even though a suit for specific performance might have resulted, on the clearly untenable theory that his contract with the company would not be complied with if he delivered certificates other than those originally "sold to him or his nominees," nevertheless, his ability to sell and to give a good title clearly resulted in the stock having for him a value equivalent to its market value.

If it be contended that Salvage's agreement (see exchange of letters, R. p. 56) whereby he lodged the certificates with the company, put it beyond his power to sell,

nevertheless that did not destroy or reduce the *value* of his interest in the Viscose Company. That was a voluntary act on his part, and the Commissioner would not contend, if he were seeking to assess a tax against Salvage for the year 1922 on income represented by the difference between $100. a share and the fair market value of $1,164.70, that Salvage could by his own voluntary act of putting the evidence of his ownership in the Viscose Company beyond his own control, thereby reduce his taxable income $1,064.70 per share on 1500 shares.

Moreover, there is nothing in the record to even suggest that had Salvage requested the Viscose Company to return to him all or some part of the shares delivered pursuant to the letters of December 30th, 1922, (R. p. 56) that his request would not have been complied with.

The principles here set out are sustained by the decided cases.

In *Newman* v. *Commissioner,* 40 Fed. (2d) 225, (certiorari denied 282 U. S. 853) an agreement between stockholders provided that no one of them could sell without the assent of the others. The Circuit Court of Appeals for the Tenth Circuit, nevertheless held, that the taxpayer's gain was to be measured by the fair market value of the stock when received, even though it appeared that in two succeeding years the taxpayer had requested permission to sell and it had been refused.

In *Helvering* v. *Kendrick Coal & Dock Co.,* 72 Fed. (2d) 330, (certiorari denied 79 L. Ed. 534) the stock certificates provided that their transfer was subject to the provisions of the "Code of Regulations" of the issuing company. Despite this, the court held the stock had a market value.

In *Henritze* v. *Commissioner,* 28 B. T. A. 1173, the stock certificates bore on their face a restriction against sale, pledge, assignment or transfer prior to a certain date. The Commissioner contended that this restriction did not affect their market value, and the Board of Tax Appeals sustained

his contention and used their fair market value as the basis of income, just as if the restriction did not exist.

Burns v. *Commissioner*, 30 B. T. A. 163, 174;

See also:

Rodrigues v. *Edwards*, 40 Fed. (2d) 408;
Wright v. *Commissioner*, 50 Fed. (2d) 727;
Tex-Penn Oil Co., 28 B. T. A. 917;
Schneider v. *Duffy*, 43 F. (2d) 642.

Lincoln Bryant v. *Commissioner of Corporations*, 197 N. E. 509, was an appeal to the Supreme Judicial Court of Massachusetts from the Board of Tax Appeals of Massachusetts. The question was whether income accrued to the taxpayer under the Massachusetts law upon the receipt on an exchange of shares of Massachusetts Utility Associates for shares of Class A stock of International Hydro-Electric System accompanied by an agreement that none of the latter stock would be disposed of without the consent of New England Power Securities Company for a period of one year. The taxpayer contended that he received no income from the exchange because the stock received could not be disposed of and therefore had no value. As to this contention, Rugg, C. J., said:

> "The limitation upon the sale of the Class A stock received by the taxpayer through the transaction was not inherent in the stock itself. It was not established by the charter or by-laws of the corporation by which it was issued. It did not appear on the face of the certificates. It was extraneous to the stock although accompanying its acquisition by the taxpayer. It arose out of a contract voluntarily made by the taxpayer with an outside party. The stock was not essentially unsalable. The same kind of stock, not held under such a contract, was freely sold in the market. The full and complete ownership of the Class A stock vested in the taxpayer at the time of the exchange. The title was absolute and unqualified, and not subject to condition. The con-

> tract did not prohibit the taxpayer from selling the stock; it permitted sale with consent of New England Power Securities Company. There is nothing in the record to indicate that the taxpayer ever sought that consent or that such consent would not have been given if requested. Attempts to restrict the normal operation of tax laws by the device of contracts on the part of the taxpayer strike at a vital function of government. They have not commonly been successful."

It is said in the Commissioner's "Memorandum for Respondent" (p. 8) that these cases are "to be distinguished from one in which the taxpayer voluntarily agrees not to sell his stock for a certain period." There may be such a distinction, but clearly there is a close analogy between an agreement not to sell to any one and an agreement to sell to a specified person (option). Both are restrictions upon the owner's disposition of his stock and both may be—and in this case were—voluntarily entered into. It is further said at the same page that *Wilson* v. *Bowers,* 57 Fed. (2d) 682, and *Markle* v. *Commissioner,* 10 B. T. A. 763, 794, support the view of the court below as to five-sevenths of the 1500 shares of Viscose Company stock.

Wilson v. *Bowers* involved an estate tax upon certain shares of a corporation held by decedent under agreements whereby others had the right to purchase at a fixed sum (provided the owner sought to sell to one not a party to the agreement) during the decedent's lifetime, and for a limited period from his estate in the event of his death. The executors sought to limit value to the agreed purchase price; the Commissioner contended for market value (the reverse of his position here), regardless of the limitations upon the salability of the stock. The court in discussing what constitutes a taxable estate under the Revenue Act of 1918 (estate tax) said these three elements must exist to give a taxable value, viz.:

1. The property must be subject to the payment of charges against decedent's estate, and

2. The expenses of its administration;

3. Subject to distribution as part of his estate.

No one of those three essential "characteristics", as the court called them, exists or need exist in a case like this, where the question is fair market value at the time of receipt by a living taxpayer. A fundamental distinction exists between "the interest therein of the decedent at the time of his death" as provided by the Estate Tax Law, and the *value* of shares of stock received by a living taxpayer, though subject to a repurchase option. This distinction is inherent in the laws, since the necessity for the existence of the "characteristics" of the estate tax does not exist with respect to income tax. If this were not true, then in those cases where "the taxpayer voluntarily agrees not to sell his stock for a certain period"—which the Commissioner apparently concedes are correctly decided—in the event of the taxpayer's death would not be subject to the estate tax, because they would not be subject to the payment of charges against the estate or expenses of administration, or subject to distribution. If the Commissioner's contention carried to its logical conclusion be sound, no simpler nor more effective method for evading estate taxes could possibly be devised.

The facts in *Markle* v. *Commissioner,* 10 B. T. A. 763, cited by the Commissioner in sustaining the decision of the court below are so different from those in this case that the Board's findings are valueless here. In the *Markle* case *all* the stockholders of a corporation gave an option upon their stock (10 B. T. A., p. 781) at $10.00 per share. They further agreed among themselves to sell at the same price (10 B. T. A. 782). This option and agreement were made *prior* to March 1, 1913, the basic date for ascertaining value, but were in effect on that date. It is not clear from the report of the case that the stock had any market value, or if it had any, it exceeded $10. a share; indeed it was possible under the circumstances existing that its value was not as

much as $10. per share, as appears from this language of the Board (p. 794):

> "They (i. e., the bondholders and stockholders) were also offered a flat cash price which, while netting the bondholders par plus accrued interest, would not have assured to stockholders anything over the $10., if that."

It rather appears from the Board's opinion that the $10. a share was taken as value, because there was no other satisfactory evidence upon which to base a different value.

For the *Markle* case to have any analogy to this case the facts here would have to be altered so that Salvage *prior* to the basic date for determining value, had given an option or entered into an agreement with *all other* stockholders of The Viscose Company to sell at $100. per share. Obviously when *all* stockholders of a corporation agree to sell at a fixed figure, that agreed figure determines the market value of the stock, but that situation does not exist in this case.

Summarizing the foregoing discussion, it is respectfully submitted that the court below erred because:

> The agreement of December 30th, 1922 (R. p. 10) did not prohibit Salvage from assigning for value all or any part of the 1500 shares of Viscose stock received by him,—on the contrary, it contemplated assignments. That Salvage if called upon to deliver to the company all or any part of five-sevenths of 1500 shares of its stock would have complied by delivering any other certificates for the required number of shares. That lodging the certificates with the company (R. p. 56) was his voluntary act and did not reduce their value from $1,164.70 a share to $100. a share. That there is nothing to show that if he had asked the company to consent to the sale of his stock it would not have done so.

Another method of considering the problem is to ascertain the purpose of the parties to and the substance of the agreement, as well as what advantages would be gained by the exercise or non-exercise of the rights given. (*Ithaca Trust Co.* v. *United States,* 299 U. S. 151; *G. & K. Mfg. Co.* v. *Commissioner,* 76 Fed. 2d 454, certiorari denied on this point No. 187 this term; *Newman* v. *Commissioner,* 40 Fed. 2d 225). In the two cases last cited the petitioners had purchased stock but had agreed not to sell within a limited period. The courts, looking at the intent of the parties, found that the agreements not to sell had been made for the advantage not only of other stockholders but of the purchasers themselves and held that the restriction in no way diminished the value of the stock. A careful examination of the record in this case shows clearly that the options to repurchase were retained only for the purpose of insuring petitioner's continuation in the service of the company and his non-competition, and that there was no intention that the options should be exercised unless petitioner broke his agreement.

Mr. Salvage was under an employment contract, (Exhibit 5, page 57) and the expiration of that contract on December 31, 1927, was coincident with the expiration of the last option to repurchase. The division of the stock into sevenths and the delivery of two-sevenths without restriction was made to compensate him fully for two previous years in which he had been underpaid (p. 43). He testified that the repurchase right was reserved in order to retain his services over a period of years (p. 38); that the company would not have sold him the stock unless he remained in its employ (p. 44); that he was willing to give the options because he was interested in the company and wished to remain (p. 44); that if the options had been exercised he would have left the company (p. 44). Mr. Salvage was the person largely responsible for the remarkable development of the company's business and his retention was obviously of great importance to the company (pp. 36, 37). The options were never exercised (p. 44), a

fact which is evidence that it was never intended that they should be unless petitioner broke his employment contract. See *Miller Industries* v. *Commissioner*, 61 Fed. 2d 412. The purpose is further shown by the application of the ordinary considerations of business conduct to the terms of the contract. The option to repurchase the entire five-sevenths of the stock, subject to the repurchase agreement, could have been exercised two days after the agreement was made. Is it conceivable that either the company or petitioner would have made such a futile agreement had there been any intention of exercising the option, which would have been so obviously to the company's advantage, had there been no other governing consideration?

Clearly the company considered it to its advantage not to exercise its right of repurchase unless petitioner broke his contract of employment, and the real option lay in him and not in the company.

Even though it be held that as of December 30, 1922, the option stock had a value of only $100. per share, nevertheless it is perfectly clear that as the options severally expired, the additional value came into the possession of the taxpayer, so that prior to 1929, the year here involved, he was in complete and unrestricted possession of all of the stock and all of its value had been received by him. The Commissioner has at all times in this case admitted, and indeed insisted, that the value of the stock, except as the same might be affected by the options, was $1,164.70 per share (stipulation, p. 14). The record also clearly demonstrates that the stock had at least this value in the years when the options severally expired (pp. 38-39).

Therefore, for the purpose of computing gain or loss in 1929, the options, whatever the Court may consider their original effect, should be disregarded and the stipulated and proven value of the old stock accepted. This value, upon apportionment, gives a basis of $110. per share for the preferred stock, the figure at which it was redeemed. No gain was realized and the taxpayer is entitled to the full refund claimed.

From all of which it appears that these 1500 shares had a fair market value on December 30th, 1922, when received by Salvage, of $1,164.70 a share, and accordingly the Circuit Court of Appeal's finding that only two-sevenths of the 1500 shares had that value should be reversed.

POINT IV.

The Circuit Court erred in making a new finding as to the value of the option stock.

The jurisdiction of the Circuit Court is limited to a review of questions of law. *Avery* v. *Commissioner,* 22 F. (2) 6; *Tricou* v. *Commissioner,* 68 F. (2) 280, 286. While in certain cases the Circuit Court has considered questions not raised below, such questions are only considered when all the facts relevant thereto are before the Court. *Helvering* v. *General Utilities and Operating Co.,* 74 F. (2) 972; *Griffiths* v. *Commissioner,* 70 F. (2) 946. The Board of Tax Appeals sustained the Commissioner and found that all of the stock of The Viscose Company on December 30, 1922, had a value of $1,164.70 per share. Such administrative findings on issues of fact are accepted by the Court as conclusive if the evidence was legally sufficient to sustain them and there is no irregularity in the proceeding. *Phillips* v. *Commissioner,* 283 U. S. 589, 600. The only fact apparently considered by the Court in this instance was the contract itself. The circumstances relating to the value of the stock on the several dates of the expiration of the option were not in evidence, except as above indicated.

Respectfully submitted,

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